Podcast Script

Episode 4: The Systemic Risk Exception

Moderator Introduction	**Diane:** Hello again. My name is Diane Ellis. Welcome to Episode 4 of the FDIC's podcast of *Crisis and Response: An FDIC History, 2008-2013*.
What This Episode Will Cover	**Diane:** In our last podcast, we introduced the systemic risk exception, the authority used to create the Temporary Liquidity Guarantee Program. Today, we'll look at how the systemic risk exception was used during the financial crisis for three of the nation's four largest banks to help stabilize financial markets and stem the cycle of fear that had gripped the global financial system.
Introduce Art and Fred	**Diane:** Joining me again today is Art Murton, Deputy to the Chairman for Policy. Welcome back Art. **Art:** Thanks Diane. Nice to be here. **Diane:** Fred Carns, Principal Advisor in the FDIC's Division of Insurance and Research, joins us again today as well. Hello Fred. **Fred:** Hi Diane.

Need for the Systemic Risk Exception	**Diane:** As we mentioned in our last podcast, the systemic risk exception, or SRE, was authorized by law in 1991 but wasn't used until the crisis in 2008. In late 2008 and early 2009, the SRE was used for three of the four largest banking organizations: Wachovia, Citigroup, and Bank of America. Art, we should probably remind listeners about what we mean by a systemic risk exception and how it was used. **Art:** Well Diane, since 1991, federal law has required that the FDIC resolve failed banks by using the method that would be least costly to the Deposit Insurance Fund. Insured depositors are made whole—they don't lose a penny—but losses are imposed on uninsured depositors and debt holders, which minimizes losses to the Fund. Congress allowed one exception to the least-cost requirement—the systemic risk exception. An SRE could be used if complying with the least-cost requirements would have serious adverse effects on economic conditions or financial stability. But an SRE could only move forward if the FDIC and the Federal Reserve Board recommended it, and the Secretary of the Treasury, in consultation with the President, agreed with that recommendation. THEN, the FDIC could act as necessary to avoid systemic problems that a major bank failure might cause, even if it wasn't the least costly way of handling the bank. **Diane:** Alright. That's helpful. So Fred, why don't you tell us about how banks in general have evolved over the years, leading to the decision to recommend an SRE for these big banks. **Fred:** Sure Diane. Well there was enormous growth in the nation's largest banks during the two decades leading up to the crisis. Between 1984 and 2007, the largest bank grew more than tenfold to $1.7 trillion in total assets, and the top four banks nearly quadrupled their share of industry assets to just under 40 percent. The largest U.S. banks became more complex and more integrated with the global financial system, and therefore increasingly vulnerable to the risks

	that triggered the financial crisis. Wachovia, Citigroup, and B of A were each exposed to the risks of the crisis in their own way, and the stress of the financial crisis would reveal that they didn't have enough capital to weather the losses that would emerge. It's easy to appreciate why regulators recommended invoking the SRE for these institutions when we remember the context in which it was being considered. The September 2008 bankruptcy of Lehman Brothers was the largest in U.S. history. It was very questionable whether the financial system could have withstood another failure of that magnitude. Had the systemic risk exception not been used for any of these big banks, there was a real possibility that the U.S. and global financial systems could have collapsed.
Wachovia	**Diane:** So the SRE was used for the first time with Wachovia? **Fred:** That's correct. Wachovia was the world's largest holder of adjustable-rate mortgages with flexible payment options—also known as option ARMs. In 2008, right after the September 25 failure of Washington Mutual Bank, which itself was the world's second largest holder of these risky mortgage loans, investors lost confidence in Wachovia, and its access to liquidity quickly evaporated. **Diane:** Art, could you give our listeners an idea of how quickly Wachovia's funding dried up? **Art:** Sure. • Washington Mutual failed on Thursday, September 25. • The next day, Wachovia's depositors accelerated withdrawals. • Deposit outflows reached almost $6 billion, or 1.5 percent of the bank's deposits. • Wachovia Corporation was unable to roll over other sources of funding. • By the end of the day, Wachovia informed its primary federal regulator—the Office of the Comptroller of the Currency—that it

	would be unable to make good on creditor claims that would come due on Monday, September 29. • Over the next two days, during what became known as "Wachovia Weekend," regulators met to determine how to resolve Wachovia. **Diane:** What options did the banking agencies have when it came to resolving Wachovia? **Art:** Well Citigroup and Wells Fargo had both proposed bids to acquire Wachovia. But both offers required government assistance that would not impose losses on Wachovia's creditors. **Diane:** Can you explain how that differed from the resolution of other banks that failed during the crisis? **Art:** Well under most "least cost" resolutions, the FDIC would be responsible for resolving the banking subsidiary, but the holding company and other subsidiaries would be resolved under the bankruptcy law. In that scenario, Wachovia shareholders would likely be wiped out and other creditors would suffer significant losses. **Diane:** And doing that would have had significant systemic consequences. So Fred, could you tell us more about what exactly made Wachovia systemic? **Fred:** Wachovia was complex and deeply interconnected with other financial institutions and markets. Many large financial firms had substantial counterparty exposure to Wachovia, and Wachovia provided back-up liquidity support to many traded instruments. Regulators thought a failure could lead to runs outside the banking sector. Losses from such a failure—including losses imposed on uninsured depositors and other debt holders—would have been a major shock to the financial markets and could even have led short-term funding markets to virtually cease operating. The FDIC, Treasury, and Federal Reserve also believed that the supply of credit to households and businesses would shrink

	substantially and that confidence in the U.S. financial system and economy would deteriorate even more. **Art:** Due to the reasons Fred just described—all of which made Wachovia a systemic risk—and because the only bids to acquire Wachovia required government assistance, policymakers decided to invoke the SRE. This was the first time an SRE had been invoked since it was created 17 years earlier. On Monday, September 29, the FDIC announced that Citigroup would acquire Wachovia in an FDIC open-bank assistance transaction. This meant that instead of allowing the bank to fail, all of Wachovia's banking operations would remain open. To prevent financial instability, government assistance was used to provide a benefit to debt holders and shareholders in addition to insured depositors. Citigroup would acquire most of Wachovia's assets and liabilities. The FDIC would agree to share future losses on a pool of $312 billion in loans, and Citi would agree to absorb up to $42 billion of future losses on the pool; if losses exceeded that amount, the FDIC would absorb them. **Diane:** But there's a twist to this story—just two days after the assistance was announced, Wells Fargo reentered the bidding with an offer to acquire all of Wachovia's operations. The new bid did not require any FDIC assistance. And the proposal benefitted Wachovia shareholders because Wells Fargo offered a price per share that was seven times higher than Citigroup's. That was $7 per share compared to $1. **Art:** Yes, that's correct. And before the end of the day on October 2, Wachovia's board had approved the merger with Wells Fargo. The next day the two banks publicly announced their merger. **Diane:** The successful acquisition of Wachovia negated any need for FDIC assistance, and no assistance was actually provided under the SRE.

	Art: Right. But the precedent had been set. Invoking the SRE signaled to financial markets that the government was willing to take action to avert systemic problems in the banking industry. **Diane:** So Wachovia was the first domino to fall. In October and November of 2008, other mega banks, like Citigroup, were having their own unique problems with high-risk assets and unstable sources of funding. Fred, can you walk our listeners through the use of the SRE for Citi and how it was different from Wachovia?
Citibank	**Fred:** Sure. On October 16, Citigroup reported a third-quarter loss of $2.8 billion that rattled the confidence of investors. Even though it received substantial government support, Citigroup's stock price continued to decline and the market began to question the firm's long-term viability. Citi had significant amounts of commercial paper and long-term senior and unsubordinated debt outstanding. It was also a major player in numerous domestic and international payment, clearing, and central counterparty arrangements and in derivatives markets. Citi's vulnerability was due to its exposure to credit and market losses and its dependence on international operations for funding. Regulators saw increasing signs pointing to a run on Citibank. **Diane:** And what happened next? **Art:** Well on November 20th, the banking agencies and the Treasury had started talking about providing more assistance to Citi and reviewing available options, but the agencies—and the bank itself—had trouble producing detailed creditor and counterparty information on such short notice. By the following day deposits were leaving the bank at such a high rate that regulators did not think that Citi would be able to pay its obligations through the next week.

Diane:

So the Treasury and banking agencies agreed that the potential failure of Citi presented a serious systemic risk. Were there any viable acquirers for the bank?

Art:

No. The other largest banks, Bank of America, JPMorgan Chase, and Wells Fargo, were not considered potential acquirers because of their previous acquisitions of—and absorption of losses from—Merrill Lynch, Bear Stearns, and Wachovia. Also, given Citigroup's size, a merger with any of these three banks would have resulted in an even larger, more systemically important bank.

Fred:

And like Wachovia, the FDIC Board of Directors determined that any action taken by the FDIC under the least-cost framework would adversely affect economic conditions and the financial markets because of Citigroup's size and its interconnectedness.

The Board also felt that allowing Citi to fail would seriously affect already disrupted credit and derivatives markets, increasing the possibility of deposit runs at banks, and would adversely affect the functioning of payments across the global financial system.

Diane:

So the FDIC Board and the Federal Reserve recommended an SRE, and the Secretary of the Treasury approved it, which allowed the FDIC to provide open-bank assistance for Citigroup. Fred, could you fill our listeners in on the details of the assistance package?

Fred:

Well, the open-bank package had two parts: a capital injection provided by the Treasury and loss protection on a pool of risky assets provided by the Treasury, the FDIC, and the Federal Reserve Bank of New York.

Citigroup received $20 billion of additional capital in exchange for preferred stock. Also, Treasury and the FDIC provided an asset guarantee on a $306 billion pool of risky assets on Citi's balance sheet. Citi was to be solely responsible for the first $37 billion in losses. Any additional losses would be shared between Citi and the government, with Citi responsible for 10 percent of the losses and the government covering 90 percent.

	Diane: Citigroup proved to be too big, too complex, and too globally interconnected to be allowed to fail. Which brings us to another unique challenge—Bank of America Corporation, or B of A—which represented another large and highly connected banking organization. Art, fill us in on how the systemic risk exception was used for Bank of America.
Bank of America	**Art:** Bank of America Corporation was a complex organization. The largest of its banking subs had $1.4 trillion in total assets, it was the second largest FDIC-insured institution. B of A's appetite for growth led it to make two acquisitions in 2008 that turned out to be far more problematic than first anticipated. The January 2008 acquisition of Countrywide Financial directly exposed B of A to the credit problems of subprime mortgages, which became more apparent as the year went on. After Lehman Brothers filed bankruptcy on September 15, 2008, Bank of America acquired the investment bank Merrill Lynch. **Diane:** But the decision to acquire Merrill turned out to expose B of A to higher losses than anticipated. **Art:** That's right. After first considering invoking its right to cancel its merger agreement, B of A ultimately decided to complete the merger on December 31, 2008, absorbing almost $16 billion in Merrill Lynch losses in the fourth quarter. Again, a complex mega bank faced the skepticism of investors as to whether it had its credit losses under control. **Fred:** And like Citigroup, B of A sought loss protection from the government to

	reassure investors and give the company a chance to get its house in order. And the FDIC, the Fed, and the Treasury faced the dilemma that arose from uncertainty about the condition of the company, its interconnectedness to the rest of the financial system, and the challenges in managing its failure. Policymakers thought that the failure of B of A could lead to systemic problems in the banking industry because of the bank's size and the volume of its counterparty transactions. **Diane:** But this case was different from Citigroup's. Even though policymakers recommended invoking the SRE, it was never formally approved by Treasury. Tell us more about that. **Fred:** With Wachovia and Citi, decision makers had very little time to react to the companies' liquidity problems. But with B of A, regulators had more time to craft an assistance package. Not only were the large losses from the Merrill acquisition known in December, but because B of A would hold its earnings call on January 16, 2009, decision makers had a sense of when potential adverse market reactions might occur and they could work to have the assistance package ready in advance. **Diane:** So what did this assistance look like? **Art:** It was similar to Citi's. It called for an injection of $20 billion in capital from the Treasury and loss protection on a pool of risky assets that would share losses between Bank of America, Treasury, the FDIC, and the Federal Reserve Bank of New York. For the pool of assets under the government guarantee, B of A would bear the first $10 billion in losses. Losses beyond that would be shared between B of A and the government, with B of A taking 10 percent of losses and the government covering the other 90 percent. **Diane:** The assistance was announced simultaneously with B of A's fourth quarter earnings call. But, again, it was never finalized.

	Art: That's correct. Before it could be finalized, Bank of America asked to terminate the asset guarantee to help reduce its reliance on government support and return to normal market funding. The Secretary of the Treasury never formally approved the SRE. But the public announcement in January signaled regulators' willingness to provide such assistance and may have achieved, to some degree, the intended effect of increasing market confidence in Bank of America.
Wrap up and Dodd-Frank	**Diane:** So we've talked today about how the systemic risk exception was used during the crisis to stabilize funding and liquidity at three of the nation's biggest banks. The decision to use the SRE was not one that was made lightly. Policymakers had to strike a balance between, on the one hand, stability and containing systemic risk, and, on the other hand, protecting the Deposit Insurance Fund and containing moral hazard. Moral hazard happens whenever stakeholders in the institution sense that they will be protected from the consequences of excessive risk-taking and therefore lack the incentives to prevent it. **Fred:** Given the severity of the crisis and the extraordinary government assistance that was provided, Congress enacted a number of financial reforms. The Dodd-Frank Act significantly increased the quantity and quality of capital that systemically important banks are required to hold. These capital requirements are meant to reduce the likelihood that large banks will fail in the future. Today, the largest U.S. banks have almost twice as much capital compared to what they had at the beginning of the crisis. **Art:** If a systemically important company were to fail, the Dodd-Frank Act requires the largest bank holding companies to prepare resolution plans or so-called "living wills" to demonstrate how the companies could be resolved without severe adverse consequences for financial stability. Dodd-Frank also gave the FDIC a back-up resolution mechanism, called the Orderly Liquidation Authority, to allow the FDIC to liquidate systemic financial companies while holding shareholders and management accountable. With these reforms in place, Dodd-Frank significantly narrowed the scope

	of the systemic risk exception. The law requires that for the FDIC to use an SRE, the financial institution must first be placed into receivership, eliminating the possibility that the exception can be used to provide open-bank assistance.
Up Next	**Diane:** Thanks Art and Fred for your insights today on the systemic risk exception. In the remainder of this series, we will discuss the banking crisis from the perspective of the FDIC's three primary business lines that were used to address it. These are supervision, deposit insurance, and resolution of failed banks. First up will be supervision. We will focus on how supervisors responded to the crisis and the lessons they learned.